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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Regulation of	)	CC Docket No. 93-179
Local Exchange Carriers	)	
	)	
Rate of Return Sharing	)	
And Lower Formula Adjustment	)	
	)	

REPLY COMMENTS

BELLSOUTH TELECOMMUNICATIONS, INC.

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September 1, 1993

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SUMMARY

In its comments in this proceeding, BellSouth demonstrated that adoption of "add back" for price cap LECs would represent a fundamental change in the LEC price cap plan that requires rulemaking, not a mere "clarification" of the existing rules. BellSouth also noted that the addition of an "add back" adjustment to the LEC price cap rules must be prospective only and cannot affect the legality of the annual access tariffs currently under investigation by the Commission. The overwhelming majority of commenting parties agree with this position. MCI, NYNEX and SNET, however, take the opposite view. These parties are clearly erroneous.

NYNEX argues that the LEC price cap plan would be legally deficient in the absence of "add back". NYNEX bases this view on the erroneous assumption that the LEC price cap plan contains prescribed "upper and lower earnings limitations". BellSouth demonstrates herein that what is prescribed in the LEC price cap plan is a sharing mechanism, not limits on earned returns. Rates that comply with the prescribed sharing mechanism are presumptively lawful, regardless of the earnings they produce. NYNEX is also in error when it argues that "add back" is necessary to avoid confiscation. The primary protection against confiscation in the LEC price cap plan is the provision for above cap

rate filings, not the lower formula adjustment. Nothing in the LEC price cap orders suggests that the Commission intended the lower formula adjustment to effectively guarantee the LECs a minimum rate of return.

MCI takes the opportunistic view that "add back" is required for sharing amounts but not for the lower formula adjustment. MCI cites not one word from the LEC price cap orders or rules to support this view. BellSouth demonstrates herein that the LEC price cap order clearly contemplated symmetrical backstops. MCI's argument is without merit. MCI's argument that "add back" is necessary to retain the status quo under rate of return regulation is equally without merit. First, since the Court of Appeals decision in AT&T v. FCC in 1988, there has been no use of "add back" because refunds of overearnings are no longer required under rate of return regulation. MCI's argument that the Commission did not change the reporting requirements for price cap LECs is also in error. It fails to recognize that the Common Carrier Bureau, on delegated authority, adopted a new Form 492A for price cap LECs that does not include "add back" calculations.

BellSouth has shown that there is no need to consider piecemeal adjustments to the LEC price cap plan on the eve of the scheduled comprehensive review. If, however, the Commission continues this proceeding and adopts an "add back" requirement, it should also adopt a credit for below

cap rates. Such an adjustment can be administered as simply as an "add back" adjustment and would offset, to some extent, the damage to the incentive structure of the LEC price cap plan that adoption of an "add back" requirement would do.

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REPLY COMMENTS

BellSouth Telecommunications, Inc. ("BellSouth") hereby replies to the comments submitted in the captioned proceeding in accordance with the Notice of Proposed Rulemaking ("NPRM"), FCC 93-325, released July 6, 1993.

In its comments, BellSouth demonstrated that adoption of an "add back" adjustment would represent a significant change in the LEC price cap plan that would require a rule change, not a mere "clarification" of the existing rules. Of the thirteen parties commenting in response to the NPRM,[1] the overwhelming majority agree with BellSouth's position on this issue. NYNEX, SNET and MCI, however, argue that "add

[1]In addition to BellSouth, parties filing comment in response to the NPRM included Ameritech, AT&T, Bell Atlantic, GTE, MCI, NYNEX, Pacific Bell and Nevada Bell, Rochester Telephone Corporation, Southern New England Telephone Company ("SNET"), Southwestern Bell Telephone Company, the United States Telephone Association ("USTA"), and U S West Communications, Inc.

back" is permitted or required under the existing rules.[2] NYNEX, SNET and MCI are clearly in error.

I. The legality of the LEC price cap plan does not depend on the existence of "add back".

NYNEX argues that the price cap system would be legally invalid if the Commission did not order "add back". NYNEX's analysis is based on the assumption that the price cap sharing mechanism creates "upper and lower earnings limitations".[3] The Commission made it clear, however, that the price cap plan contains no "upper and lower earnings limitations". The Commission prescribed a sharing mechanism, not a limitation on lawful earnings.[4] Under the

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[2]MCI argues for "add back" for sharing amounts, but its comments are vague as to whether it contends that "add back" is required under the existing price cap rules, or whether "add back" for sharing amounts should be added to the price cap rules in this proceeding. In its Opposition to Direct Cases in CC Docket No. 93-193, filed August 24, 1993 ("MCI Opposition"), however, MCI argues in favor of applying "add back" in connection with the current access tariff filings, thus implying that "add back" is required under the current price cap rules.

[3]NYNEX Comments at 3. See also AT&T Comments at 2: "Under this mechanism, a LEC that achieves earnings in excess of the prescribed rate of return in the base period may be required to share those excess earnings with ratepayers in the succeeding year, in the form of an exogenous adjustment to the LEC's price cap." As shown in the text, this is a complete misrepresentation of the LEC price cap plan.

[4]See, e.g., LEC Price Cap Order at para. 128, wherein the Commission stated:

> These backstop sharing and adjustment mechanisms are adopted as rules pursuant to Section 201 through 203, and as a prescription pursuant to 205(a), and 4(i) of the Communications Act. Except as provided below, proposed rate changes that fail to comply with these rules (e.g., rates

LEC price cap plan, high earnings trigger the application of the sharing mechanism. While this mechanism may effectively limit LEC earnings over time, in any given year a LEC may earn, and keep, whatever level of earnings its operations produce. So long as the LEC complies with the sharing mechanism in establishing the subsequent year's PCI, and its rates remain below cap, the requirements of the Commission's prescription are satisfied and its earnings are lawful.

The Commission made this abundantly clear in the LEC Price Cap Reconsideration Order[5], when it stated:

> We have determined that overall earnings produced by rates that comply fully with price cap requirements will be just and reasonable. Accordingly, a complaint against a price cap carrier that is based solely upon the theory that rates are unjust and unreasonable because the rates produced such earnings would be dismissed. This approach is no different than under rate of return regulation, where a complaint is dismissed

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> that fail to incorporate rate reductions mandated by earnings in the 50-50 sharing zone or all sharing zone, or rates that are based upon an improperly calculated PCI or that do not accurately reflect the computed rate reductions) will be subject to rejection or other appropriate corrective action. In addition, to the extent they become effective, rates that fail to comply with these rules will be subject to enforcement action appropriate to correct the violation of a prescription under Section 205(a), including forfeitures, or complaints under Section 208. In light of our prescription of the sharing and adjustment mechanisms, complaints claiming that overall company earnings that comply with the sharing mechanism are excessive in view of costs will not lie. . . . (Emphasis added)

[5]In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Order on Reconsideration, 6 FCC Rcd 2637 (1991) ("LEC Price Cap Reconsideration Order").

> if it argues that a carrier's overall earnings are unjust and unreasonable even though they comply with the prescribed rate of return."[6]

In order to evaluate compliance with a prescription, it is first necessary to determine what has been prescribed. Under the Commission's prior regulatory regime, the Commission prescribed a rate of return. The Commission interpreted such a prescription as creating a "maximum allowable rate of return".[7] The Commission determined that any earned rate of return in excess of the maximum allowable rate of return would be considered unlawful. It prescribed a refund mechanism that included an "add back" requirement to enforce the rate of return prescription.

Under price cap regulation, the price cap index and the sharing mechanism are prescribed, not a rate of return. Compliance with the PCI and the sharing mechanism constitute compliance with the prescription, and earned returns are irrelevant to the lawfulness of a carrier's rates. NYNEX therefore fundamentally misstates the Commission's price cap plan when it refers to "upper and lower earnings limitations", and AT&T is clearly incorrect when it refers to a prescribed rate of return.

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[6]LEC Price Cap Reconsideration Order at para. 202.

[7]See 47 C.F.R. § 65.700.

II. The primary protection against confiscation in the LEC price cap plan comes from the ability of carriers to file above cap rates, not from the lower formula adjustment.

NYNEX contends that "add back" is necessary if the lower formula adjustment is to prevent confiscation.[8] NYNEX points to the "seesaw" earnings pattern that would occur if a carrier's operations, absent the lower formula adjustment, produced earnings year after year at an eight percent rate of return.[9]

This argument is invalid. The Commission clearly intended the lower formula adjustment as a safety net to protect carriers against unusual circumstances that might depress their earnings over a short period of time. However, the lower formula adjustment was not intended to guarantee a LEC a certain minimum level of earnings every year, regardless of the carrier's cost structure or productivity gains. Thus, the Commission repeatedly conditioned its description of the lower formula adjustment as a one-year, temporary adjustment, not an earnings floor. For example, in the LEC Price Cap Reconsideration Order, the Commission stated:

> LECs are reasonably expected to become more efficient in order to earn higher profits, or even to maintain their current profits. LECs can control costs and become more efficient. If the formula applies harmfully to any particular LEC, the lower adjustment mark offers a remedy, while

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[8]NYNEX Comments at 9.

[9]NYNEX Comments at 6.

> still providing an incentive to become more profitable by increasing efficiency, not rates.[10]

In the LEC Price Cap Order, the Commission stated:

> A backstop mechanism can also serve to ensure that application of the formula does not subject any price cap LEC to depressed earnings over an extended period of time that could impair such LEC's ability to provide quality service to local subscribers.[11] (Emphasis added)

Elsewhere, the Commission stated:

> We are also adopting a modified version of our proposed lower stabilizer or low end adjustment mechanism in order to ensure that the application of the price cap plan does not subject any individual LEC to such low earnings over a prolonged period that its opportunity to attract capital and ability to attract service are seriously impaired.[12] (Emphasis added)

If a carrier found itself in the situation posited by NYNEX, i.e., a situation where, despite effective management, the price cap plan would permit it to earn no more than an eight percent rate of return year after year, the Commission provided another safeguard against confiscation: an above cap rate filing.

An above cap rate filing is the principal protection against confiscation in the LEC price cap plan. This was

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[10]LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2691, para. 117.

[11]LEC Price Cap Order at para. 121.

[12]LEC Price Cap Order at para. 127. See also para. 164, where the Commission states: "Therefore, we will select a level that is below the level of earnings available under traditional rate of return regulation, yet not so low as to cause a confiscatory result in the short term." (Emphasis added)

repeatedly noted by the Commission.[13] Indeed, the Commission noted that above cap filings operate in tandem with the lower formula adjustment to protect carriers against confiscation.[14] Thus, the fact that, absent "add back", the lower formula adjustment would not guarantee a minimum level of earnings does not call into question the legality of the LEC price cap plan.

Both NYNEX and SNET cite footnote 166 of the LEC Price Cap Reconsideration Order as the source of the alleged requirement to include an "add back" adjustment under the existing LEC price cap rules.[15] That footnote supports the opposite conclusion than that drawn by NYNEX and SNET. Footnote 166 provides:

> [166] We agree with AT&T that PCI adjustments to bring a LEC's earnings up to the lower adjustment mark will be one-year adjustments. AT&T Petition at 8 n.*. This is in keeping with the one-year adjustments made to effect sharing. In response to USTA's argument that the upward adjustment should not be deleted from the PCI, we note that if a LEC continues to operate below the lower adjustment mark, the LEC will be subject to a

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[13]See LEC Price Cap Order at para. 165 and 364; LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2691, para. 117.

[14]LEC Price Cap Order at para. 304; LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2691, para. 117.

[15]See NYNEX Comments at 10, fn. 11; SNET Comments at 2, fn. 6.

subsequent PCI adjustment. See USTA Opposition at 17.[16]

If the existing rules required "add back", USTA's request that the upward adjustment should not be deleted after one year would be meaningless. As NYNEX's Attachment A shows, with "add back" a carrier that implements a lower formula adjustment in a given year, and whose costs and revenues do not change in subsequent years, would perpetually receive lower formula adjustments, and would perpetually achieve a 10.25% rate of return. The result would be the same as USTA's proposal, which the Commission rejected.

It is also significant that footnote 166 follows a reference in the text of the LEC Price Cap Reconsideration Order noting the need for efficiency incentives in the LEC price cap plan and the availability of above cap filings to avoid a confiscatory outcome.[17] That reference would hardly have been necessary if "add back" had been a required feature of the LEC Price Cap Plan.

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[16]It is significant to note that AT&T, whose argument was credited by the Commission in this footnote, agrees with BellSouth that the existing price cap rules do not permit an "add back" adjustment. Although AT&T supports the adoption of an "add back" adjustment in this proceeding, it recognizes that such rules will have prospective effect only, and would not apply to access rates being investigated under the existing rules. See AT&T Comments at 6.

[17]LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2691, para. 117.

III. Adoption of an "add back" mechanism requires a rule change, not mere "clarification" of an existing rule.

Finally, NYNEX argues that the adoption of "add back" would not be a new rule, but merely a "clarification" of the existing LEC price cap rules, because the instructions for Form 492A require that carriers report "normalized" revenues. BellSouth discussed this argument at length in its comments and will not repeat those arguments here. It is sufficient to note that NYNEX's interpretation is totally at odds with the way "add back" was implemented on Form 492 under rate of return regulation and with the instructions adopted by the Common Carrier Bureau for Form 492A for price cap LECs.

IV. MCI's opportunistic argument that "add back" is required for sharing but not for the lower formula adjustment is without merit and must be rejected.

The only other party asserting that "add back" is required under the current LEC price cap plan is MCI.[18] MCI takes the opportunistic position that "add back" is required under the LEC price cap plan for sharing but not for lower formula adjustments.[19] MCI cites nothing in the LEC price

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[18]BellSouth notes that although the Ad Hoc Telecommunications Users Committee ("Ad Hoc") did not file comments in this proceeding, it filed comments on the direct cases in CC Docket No. 93-193 that largely parrot the arguments advanced by MCI. In the event that Ad Hoc should attempt to make such arguments in the reply phase of this proceeding, BellSouth's responses to MCI are applicable to Ad Hoc as well.

[19]Nowhere in its comments in this proceeding does MCI clearly state that "add back" is required under the existing LEC price cap plan. Nor did MCI petition against the 1993

cap rules or orders that would support its apparent assertion that "add back" of sharing amounts is required under the existing rules. Instead, MCI makes a philosophical argument that "add back" is necessary to fully effectuate refund/sharing obligations of LECs. MCI states:

> To summarize, the only role that earnings monitoring plays in the rate setting process is to ascertain whether or not LECs exceeded the level of earnings to which they are legally entitled. ... In the event that LEC earnings exceed the allowed level, prospective rates are reduced with regard to such overearnings/sharing amounts. ..."[20]

BellSouth has demonstrated above that the requirement for refunds under the rate of return enforcement rules and sharing under price caps arise under very different applications of the Commission's prescription power under Section 205(a) of the Communications Act. When the Commission prescribed a rate of return, it interpreted that prescription as rendering unlawful any earned return in

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annual access tariff filings of BellSouth and other LECs that did not include an "add back" adjustment. Nevertheless, in its Opposition to Direct Cases, MCI cites its comments in this proceeding to argue that an "add back" adjustment for sharing, but not for lower formula adjustment, should be required in connection with the current access tariff filings. Thus, MCI is either arguing that "add back" for sharing is required under the current LEC price cap rules, or that the results of this pending rulemaking should be applied retroactively to the current tariff investigation. As BellSouth demonstrated in its comments and in these reply comments, either position is without merit and must be rejected.

[20]MCI Comments at 19.

excess of that permitted under the prescription. "Add back" was consistent with such a prescription.

Under the LEC price cap plan, a sharing mechanism, not earnings levels, are the subject of the prescription. The Commission has expressly held that earnings levels above the sharing threshold are lawful. Since variations in earnings do not result in "unlawfulness" under the LEC price cap plan, there was no need for an "add back" requirement in the LEC price cap plan, and none was adopted by the Commission.

V. No "add back" is required for overearnings under the Commission's current rate of return rules since no refunds for overearnings are required.

MCI's only other justification for imposing an "add back" requirement is its assertion that this will simply extend the status quo under rate of return regulation. MCI asserts:

> Under rate of return regulation, refunds made during a current enforcement period were and continue to be excluded from the current period earnings by way of the add-back. ... This is the sole reason for the only kind of add-back allowed when calculating rates of return under rate of return regulation.[21]

MCI overlooks the fact that since the Court's decision in AT&T v. FCC [836 F.2d 1386 (D.C. Cir. 1988)] there have been no "refunds" resulting from overearnings under rate of return regulation. In 1988 "add back" ceased to be an issue, and no LEC filing a Form 492 since AT&T has had a refund obligation resulting from "overearnings". Thus, the

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[21]MCI Comments at 10.

status quo under rate of return regulation is that "add back" does not exist. If, as MCI asserts, the Commission's intent going into price caps was to continue to calculate and report earnings as was done on Form 492 under rate of return regulation, no "add back" was needed since refunds for "overearnings" were eliminated in 1988.

VI. MCI's argument that the Commission intended different rules for "add back" of sharing and lower formula adjustments is spurious.

The bulk of MCI's comments advance the spurious argument that the Commission intended to include "add back" related to sharing, but not to lower formula adjustments. Significantly, MCI cites not one word from the Commission's orders to support this position. The Commission clearly intended that the two backstop mechanisms, sharing and lower formula adjustment, operate symmetrically. For example, in the LEC Price Cap Order, the Commission stated:

> We also view it as desirable for the formula adjustment mark and the top of the no-sharing zone to be symmetrical, because such symmetry will provide an equal balance of risk and reward over the range of results that we deem likely in the initial period of the price cap plan.[22]

Virtually every argument that MCI advances in objection to the "add back" of lower formula adjustment applies with equal force to "add back" of sharing amounts. As MCI correctly notes, "the calculation of earnings is simply intended to find out what actually happened in a prior

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[22]LEC Price Cap Order at para. 164.

period, not what might have happened had certain events not occurred."[23] "Add back" distorts the actual results that were obtained in a prior period, whether the amount "added back" relates to sharing or lower formula adjustment. MCI's argument that sharing amounts should be added back but lower formula adjustments should not, is therefore internally inconsistent and must be rejected.

In its Opposition to Direct Cases[24], MCI argues that since "there has been no change in Form 492", it is disingenuous for price cap LECs to argue that the adoption of "add back" would constitute unlawful retroactive rulemaking. MCI conveniently overlooks the fact that price cap LECs do not report earnings on FCC Form 492, but on FCC Form 492A. FCC Form 492A was adopted by the Common Carrier Bureau on delegated authority for the express purpose of reporting earnings of price cap LECs. FCC Form 492A does not include the "add back" calculations required on FCC Form 492 for rate of return carriers. Therefore, it is MCI, not the LECs, that is being disingenuous with its reference to FCC Form 492.

VII. If the Commission adopts "add back" in this proceeding, it should also adopt a credit for below cap rates.

BellSouth has demonstrated that the existing price cap plan does not require or permit "add back". BellSouth has

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[23]MCI Comments at 4.

[24]MCI Opposition at 28.

also shown that any rules adopted in this proceeding that would incorporate an "add back" requirement must be given prospective effect only, and cannot be used to evaluate the lawfulness of BellSouth's annual access tariff now under investigation by the Commission. If, however, the Commission elects to incorporate an "add back" requirement to the LEC price cap plan for the future, it should also adopt a credit for below cap rates. Such a credit will ameliorate, to some extent, the damage done to the price cap incentive structure by the addition of an "add back" requirement.

In the comments received by the Commission on this issue, only AT&T and NYNEX argue against the credit for below cap rates. Neither party provides any valid argument against the adoption of the credit if the Commission adopts an "add back" requirement. AT&T simply argues that the Commission rejected a similar proposal in the LEC Price Cap Order.[25] However, the Commission rejected the proposal in a different context. As shown above, the LEC price cap plan currently in effect does not require "add back". In this proceeding, the Commission proposes to adopt an "add back" requirement that admittedly will damage the incentive structure of the LEC price cap plan.[26] Therefore, the Commission's prior rejection of a credit for below cap rates

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[25]AT&T Comments at 4, fn. 6.

[26]NPRM at para. 14.

should not determine the outcome in this proceeding, in which the Commission proposes a significant modification to the original plan. The Commission should recognize that if it acts to dampen the efficiency incentives in the LEC price cap plan by adopting an "add back" requirement, it is appropriate to offset some of these effects with a credit for below cap rates.

NYNEX opposes the credit on the basis that its implementation is too burdensome. However, there is no need to burden the calculation of the credit with the complexity posited by NYNEX in its comments.[27] To the contrary, BellSouth demonstrated in its comments that the credit can be implemented with a calculation on FCC Form 492A that is no more complicated that an "add back" calculation.

NYNEX's argument that the issue of a credit for below cap rates is unrelated to the "add back" issue is based on NYNEX's erroneous assumption that "add back" is already required in the LEC price cap plan. BellSouth supports the credit because it will improve the LEC price cap plan by increasing the incentive for LECs to price below the cap while offsetting to some degree the damage to the incentive structure of the LEC price cap plan that would result from the addition of an "add back" requirement.

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[27]NYNEX Comments at 12-13.

IX. Conclusion.

In conclusion, the comments overwhelmingly support BellSouth's position that the addition of an "add back" mechanism requires a rule change that will have prospective application only. No good reason has been shown for considering this issue now, as opposed to including the issue of "add back" in the upcoming comprehensive price cap review. If, however, the Commission decides to adopt an "add back" requirement at this time, it should also adopt a credit for below cap rates.

Respectfully submitted,

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September 1, 1993

CERTIFICATE OF SERVICE

I hereby certify that I have this 1st day of September, 1993 serviced all parties to this action with a copy of the foregoing REPLY COMMENTS by placing a true and correct copy of same in the United States mail, postage prepaid, addressed to the parties as set forth on the attached service list.

Gordana Coley

Gordana Coley

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